Independent Directors and Insider Control in Chinese Listed Companies : A Practical Economic Analytical Framework of Law

著者	Tang Linyao
journal or publication title	東北法学
number	48
page range	65-85
year	2017-09-30
URL	http://hdl.handle.net/10097/00124068

論　説

Independent Directors and Insider Control in Chinese Listed Companies：A Practical Economic Analytical Framework of Law

中国における上場会社の社会取締役とインサイダー・コントロール：一つの実用的な法と経済学の分析枠組

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Introduction

Insider control is an essential problem in Chinese corporate governance, and independent director system was once regarded as a possible cure. However, in China, social ties play critical part in many aspects of doing business. In the corporate world, while independent directors are supposed to be "independent", such a title does not cut their social ties with corporate insiders such as CEO, CFO, manager, actual controller of firm or the controlling shareholder. These bonds arise out of educational background, industrial overlap, shared regional origin, military service or even third-party connection, representing informal connections that are not captured in conventional measures of independence.

In order to rectify the previous studies' overlook of informal connections as a vital parameter, the investigator of this research project intends to provide a possible analytical framework to explore the potential pattern embedded within the connections between independent directors and corporate insiders in the context of corporate misconduct. The underlying hypothesis is: Connections between independent directors and corporate insiders are not all detrimental; nonprofessional bonds formed out of educational and non-business experiences would increase the chance of corporate misconducts, whereas professional bonds stems from a shared industrial background or similar employment history tends to decrease corporate misconducts.

Keywords : Corporate misconduct, independent director, corporate insider, social connections

I. Failure of Independent Director System in China

In one official document entitled *Opinion on the Establishment of an Independent Director System in Listed Companies* (hereinafter the *Opinion*) by the *China Securities Regulatory Commission (hereinafter CSRC)*, the CSRC specified that by June 2003 independent directors should be constituted in the board of directors for at least one-third of listed companies in China. The 2005 amendments to the PRC Company Law solidified this mandate. The independent director requirement was thereafter introduced to Chinese listed companies as a major regulatory measure to address the issue that most corporate boards are dominated and controlled by controlling-shareholders and insiders.

Notably, criticism of independent directors in China centers on the degree of independence, or more precisely, the degree of lack of independence, from the controlling shareholders and other corporate insiders. Corporate insiders, as defined in "the Opinion", refer to CEO, CFO, manager, actual controller of the firm, controlling shareholder, or whoever has the power to affect firm decisions. The Opinion defines "independent" as "directors with neither financial nor familial ties to the major shareholders and board members". The Opinion also includes a list of negative standards which disqualify an individual to be regarded as independent. However, absent from the above guidelines, are social connections, which are so firmly embedded into Chinese culture. This, in the opinion of the author, largely endangers the core value of the independent director system.

Ex ante regulations adopted by New York Stock Exchange or National Association of Securities Dealers Automated Quotations can hardly ensure the impartiality of directors, federal courts in the U.S thus exercise an *ex post* judicial review over the true independence in shareholder-derivative suits. In contrast, in China, there is no *ex post* judicial review and derivative suits are rare. Therefore, there is no legal mechanism to challenge any improper connections and communications between independent directors and corporate insiders.

China is not alone in the aspect: as most East Asian countries subsequently adopted the independent director system from the U.S while at the same time are more or less influenced by Chinese culture which fosters close relationships between directors and managers, the degree of independence of independent directors has become a common issue in many Asian countries.

This has been a controversial issue. Previous studies suggest two different effect of social connections. Some argued that such social connections may be one ironic cause for information asymmetry *(Ma and Khanna, 2013)*, insider-control *(Wang, 2008)* and single-shareholder dominance *(Lin et al., 2012)*, issues of Chinese corporate governance that the independent director system was introduced to mitigate in the first place. On the other hand, however, others argued that independent directors with social ties to management are better informed and can thereby advise and monitor the operation of the company with more efficiency *(Tan et al., 2010; Faleye et al., 2011).*

The dual effect of different forms of social connections is crucial. Social ties among independent directors and corporate insiders are unavoidable. An objective study on these connections is crucial to re-evaluate the independent director system in China, and thereby provides insight to avoid the "transplant effect" which refers to the ineffectiveness of legal transplantation from the origin country *(Shi, 2010).*

This research intends to bring up a possible economic analytical framework for future research by providing insights into the the following questions: First, what are the potential patterns of social connections between independent directors and corporate insiders in China? What are the separate impact of those connections on corporate misconduct? Second, do social connections between independent directors and corporate insiders encourage company misconduct? If yes, to what extent? Last but not the least, how should policy makers comprehend social connections between independent directors and corporate insiders? What kind of legal reform is necessary to address such ties?

Ⅱ. Types of Connections between Independent Directors and Corporate Insiders

The dual effect brought by different forms of social connections on corporate misconduct is the core of the proposed research. The impact of networking on corporate behaviors has been studied by a number of scholars. Social network researchers suggested that any one type of network could have positive or negative effects *(Mullainathan et al., 1998; Wallman, 2005). Robert and Abbie (2003)* argued that whether personal connectedness promote or harm financial report quality depends on information cost of firms *(see also Lambert et al., 2006; Omer et al., 2015). Cohen, Frazzini and Malloy (2008)* reported that common educational background between board directors facilitate management efficiency. *Schmidt (2009)* studied the bad influence of connectedness between CEO and directors in mergers and acquisitions employing social ties as a RHS variable *(See also Cai and Sevilir, 2009; Ishii and Xuan, 2009).* Some evidence in these findings were carefully examined in order to generate points for this debate.

There is burgeoning literature exploring the legal implications of social networks between executives and independent directors in China. *Wang and Xiao, (2005)* concluded that CEO-director ties are pernicious to firm performance *(See also Luo and Tang, 2007). Li (2010)* found that social connections between a director and CEO create a risk of corruption in Chinese SOEs *(see also Ko and Weng 2011). Ye and Zhang (2011)* reviewed CEO-director connectedness and independent directors' voting behavior. *Chen and Xie (2012)* discussed independent director social relations and CEO remuneration. More recently, *Chen, Wang and Lin (2014)* analyzed independent directors' board networks and controlling shareholders' tunneling behavior; *Zhu et al. (2015)* explored the board hierarchy in China and its relation to firm value. These papers on social networks tend to focus on network centrality such as degree centrality, closeness centrality and eigenvector centrality. Still, there is no clear and conclusive description of what the social connections are. Almost all those studies focused on a general term referred to as *guanxi*, which means social ties or personal connections in Chinese. This proposed research will add to the current debate not only by reassessing the role of independent directors in corporate misconduct, but also by identifying different forms of *guanxi* that existed in Chinese business practice and by providing empirical evidence on how those social connections shape the Chinese corporate governance environment.

Grosman and Wright (2015) suggested that shared characteristics and experiences ease communication and facilitate mutual understanding, thereby fostering personal connections *(See also Westphal and Milton (2000), Zhang et al. (2014); Ni (2015))*. This research will begin with operationalizing informal ties between independent directors and corporate insiders through shared qualities and experiences.

Preious empirical studies with regression analysis have inspired the proposed research. *Chidambaran, Kedia and Prabhala (2011)* examined the separate impact of professional and nonprofessional CEO-director connectedness on financial fraud. Data set of this research is a modified version of the sample constructed by CKP updated to December 2014 and applied to China. *Hwang and Kim (2009)* associate connections arising from military experience, regional origin and third-party connection with greater tunneling behaviors by controlling shareholders. Their classification of social ties is illuminating and suitable for analyzing the way social ties are formed in China.

Following the method of *Chidambaran, Kedia and Prabhala (2011),* the author classifies social connections between independent directors and corporate insiders as professional and nonprofessional.

Professional connections arise out of academic discipline and industry overlap. *Westphal (1999) and He et al. (2009)* pointed out that professional advising and counseling is more likely when CEOs and directors come from the same industry or share similar academic way of thinking. *Adams and Ferreira (2003)* further documented that having similar prior employment history with a CEO can help independent directors better judge a CEO's actions and therefore leads to better monitoring. From both perspectives, the beneficial effect of professional connections are consistent with the "collaborative board view" in behavior research, which suggests professional ties facilitate greater professional interactions and closer advisory relationships, leading management executives to avert opportunistic behavior *(Wong and Simon, 2011; Hsu and Wu, 2013).*

The second category are the nonprofessional connections. Following the method of *Hwang and Kim (2012)*, the following measures are taken into consideration: alma mater, military service, regional origin and third party connection. Same educational background and military service enhance interaction via shared traditions and sense of group identity *(Crosse et al., 2004; Huang and Pan, 2010)*. Regional clustering of dialects, culture and lifestyle contributes to an affinity for others from the same locale *(Greenberg et al., 2011)*. A mutual third-party connection strengthens bonds and facilitates relationship building *(Granovetter, 2005)*. While these types of informal bonds can positively improve teamwork, they can also undermine the independent directors' oversight function *(Gao et al., 2006; Tung, 2011)*. Which of the two effects dominates is ultimately an empirical issue that will be determined by data analysis.

The anticipated result is: in China, professional connections would reduce corporate misconduct probability, while nonprofessional connections would increase the likelihood. The author would go deeper into analyzing and making conclusions regarding to this hypothesis based on the data.

Ⅲ. Logit and Probit Model

In order to identify different types of social connections and examine varying degrees of influence of these bonds in the operations of companies, economic analysis is critical. Through a regression equation between social connections and corporate misconduct in a logit model, the degree of responsibility to the occurrence of corporate misconduct is revealed.

'Logit and probit' model is widely used in sociology, economics and strategic management research for dichotomous or binary outcome variables. Since the goal of this research is to address the legal issues in Chinese corporate governance through investigating what effect of independent directors - corporate insiders' social connections has on corporate misconduct, an outcome that is binary in nature (misconduct either happens or not happen), a logit model would be a suitable method for the intended study. The vectors of social connections between independent directors and corporate insiders should be identified beforehand to run the regression.

A. Data

Primary data source of this research on independent directors and the corporate insiders (including CEO, CFO, managers, actual controller of firm and controlling shareholder) will be collected from the TDX database and TOPVIEW database. Corporate misconduct data will be collected from the CSRC official website, CSRC internal disclosure and CNINFO database. Firm financial performance data, accounting data will be collected from CSMAR database. This study contains 629 A-share Chinese listed companies from January 2005 to December 2014, 392 of which violated regulatory rules or received warnings from CSRC or CSRC dispatched offices.

Data on sample firm's independent directors' and core corporate insiders' academic discipline, employment history, alma mater, military service and regional origin will be hand-collected from the TDX database and other relevant public sources. To determine each subject's discipline, education background and regional origin, resumes provided by TDX database will be explored. For those whose files are blank, a cross-search of their backgrounds from CSMAR and TOPVIEW database will be conducted. Afterwards, industry ties can be defined using the Fama and French (1997) 49-industry classification. The data would be cleaned and coded for each individual and aggregated at firm level for each fiscal year. Social connections will be probed and categorized by the roles played by every subject when the bonds were formed. Furthermore, to make the investigation thorough and precise, additional information will be collected from Enterprise Yellow Page China, proxy disclosures, Chinese SOE Index and other relevant databases, if necessary.

B. Regression Variables

1. Dependent Variable

In analyzing how different socials ties may lead to corporate misconduct, the degree of propensity to corporate misconduct is set to be the dependent variable, while different social ties is set to be the explanatory variables.

The research will use a binary variable to proxy corporate misconduct. Misconduct behaviors including: involvement in related party transactions, misuse of company funds by controlling shareholders, tunneling behaviors, financial reporting fraud, market manipulating behavior (which are the five most common type in CSRC announcements) and other wrongdoings that against CSRC regulation or Chinese Security Law. The dependent variable equals 1 if the firm engages in corporate misconduct in the fiscal year and 0 otherwise.

2. Professional Connections and Nonprofessional Connections

Independent directors are classified as having professional connections with corporate insiders if they come from the same academic discipline or shared working experience in the same industry. Independent directors are classified as having nonprofessional connections with corporate insiders if they attended the same university, served in the army, come from the same locale or share a social tie with a common third-party.

Those connections will be graded further in the multivariate analysis by the nature of those ties and by the type of the firm at which the bonds were formed. These univariate differences will be examined using a logit specification that controls for all explanatory variables simultaneously.

3. Other Control Variables

Motivated by prior research, the following control variables should be added to account for various economic and governance factors that affect firm's propensity to misconduct. Those variables will be included in all the logit specifications to follow.

First, variables regarding firm characteristics are important. The firm size would be controlled using a log of total assets. Profitable firms are reluctant to cross legal lines *(Uzzi, 1996; Jiang and Yue, 2005)*. Profitability would be controlled by including the ratio of EBITDA[(1)] to total assets. Moreover, high-growth companies have the incentive to engage in fraud when facing reduced growth opportunities *(Povel et al., 2007; Tang et al., 2005)*, and growth opportunities would be controlled by including Tobin's Q, following *Davis, Fama and French (2000)*.

Second, variables regarding board and independent director characteristics should not be ignored. Board size and the ratio of independent directors are positively related to corporate misgovernance (Soliman and Ragab, 2013). Independent director with multiple independent directorships tend to do their job better since they care more about their reputation *(Yermack, 2003)*. The number of other independent directorships held by each independent director of the firm will be counted and then be averaged across all directors. As observed by many Chinese scholars, hiring scholar, retired government official or accountant as independent directors lead to different governmental climate of a firm *(Li et al., 2004; Xiao et al., 2009)*. Three different dummy variables are created to testify this view point respectively. Moreover, Chinese scholars also found that, when chairman of the board and CEO of the firm is the same person in Chinese listed companies, the CEO is more likely to misuse his power, thereby lead to more corporate malfeasance in practice *(Yu and Xia, 2004; Wang, 2007; Ju and Pan, 2010)*. A dummy variable will be tested to proxy this situation in China.

C. Logit Model

1. Overview

In order to test different types of social ties and their effect on corporate misconduct, Binary Logistic Regression Method is appropriate. Vectors of connections between independent directors (hereinafter ID) and corporate insiders (hereinafter CI) in the logit model are listed below. Coefficient of each variable would be interpreted to determine whether it will increase or will decrease the likelihood of corporate misconduct. Then, different effects of the variables will be entangled subsequently in the multivariate logit specification in section 3.3.3. Vectors of director and board characteristics will also be included in additional tests. These vectors not only serve as a robustness tests but are also as an independent test to deliver a more precise picture in Chinese corporate governance.

2. Descriptive statistics

Variable Name	Description
Dependent Variable	
MISCON	Equals 1 if the firm engages in corporate misconduct in the fiscal year and 0 otherwise
Professional Connections*	
ACA_SCALE	Number of IDs who shares/shared same academic discipline with the CI
DST_SCALE	Number of IDs who shares/shared industry overlap with the CI
Nonprofessional Connections*	
EDU_SCALE	Number of IDs who graduated from the same university with the CI
MIL_SCALE	Number of IDs who also served in the army as the CI
LOC_SCALE	Number of IDs who comes from the same locale as the CI

THI_SCALE	Number of IDs who shares/shared a social tie with a common third-party with the CI
Independent Director and Corporate Insider Characteristics	
BOA_SIZE	Number of directors of the board
IND_FRA	Percentage of IDs on the board
DIR_NUM	Average number of Independent Directorship held by IDs
SCHOLAR	Dummy Variable: equals 1 if the board has a scholar as ID and 0 otherwise
OFFICAL	Dummy Variable: equals 1 if the board has a retired government official as ID and 0 otherwise
ACCOUNT	Dummy Variable: equals 1 if the board has an accountant or financial expert as ID and 0 otherwise
CHA_CEO	Dummy Variable: equals 1 if chairman of the board and CEO of the firm is the same person and 0 otherwise
Firm Characteristics	
FIR_SIZE	Log of book value of assets of the firm
EBITDA	Earnings before interest, taxes and depreciation scaled by total assets
TOBINQ	Market value to book value

*All variables of social ties are scaled by the number of directors in the firm's board.

3. Regression Equations

Baseline Model for Corporate Misconduct

$$MISCON^{*} = \beta_0 + \beta_1(BOA\_SIZE) + \beta_2(IND\_FRA) + \beta_3(DIR\_NUM) + \beta_4(SCHOLAR) + \beta_5(OFFICAL) + \beta_6(ACCOUNT) + \beta_7(CHA\_CEO) + \beta_8(FIR\_SIZE) + \beta_9(EBITDA) + \beta_{10}(TOBINQ)$$

Corporate Misconduct and ID-CI Professional Connections

$$MISCON^{*} = \beta_0 + \beta_1(BOA\_SIZE) + \beta_2(IND\_FRA) + \beta_3(DIR\_NUM) + \beta_4(SCHOLAR) + \beta_5(OFFICAL) + \beta_6(ACCOUNT) + \beta_7(CHA\_CEO) + \beta_8(FIR\_SIZE) + \beta_9(EBITDA) + \beta_{10}(TOBINQ) + \beta_{11}(ACA\_SCALE) + \beta_{12}(DST\_SCALE)$$

Corporate Misconduct and ID-CI Nonprofessional Connections

$$MISCON^{*} = \beta_0 + \beta_1(BOA\_SIZE) + \beta_2(IND\_FRA) + \beta_3(DIR\_NUM) + \beta_4(SCHOLAR) + \beta_5(OFFICAL) + \beta_6(ACCOUNT) + \beta_7(CHA\_CEO) + \beta_8(FIR\_SIZE) + \beta_9(EBITDA) + \beta_{10}(TOBINQ) + \beta_{11}(EDU\_SCALE) + \beta_{12}(MIL\_SCALE) + \beta_{13}(LOC\_SCALE) + \beta_{14}(THI\_SCALE)$$

Robustness Tests on ID-CI professional Connections and ID Characteristics

$$MISCON^{*} = \beta_0 + \beta_1(ACA\_SCALE) + \beta_2(DST\_SCALE) + \beta_3(DIR\_NUM) + \beta_4(SCHOLAR) + \beta_5(OFFICAL) + \beta_6(ACCOUNT) + \beta_7(CHA\_CEO)$$

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